## III. The Russian Federation Does Not Adequately Permit Foreign Investment

### A. Summary of Comment

The Russian Government continues to substantially restrict foreign investment through various legal limitations on foreign participation. Equally important, the government's failure to implement structural reforms has *de facto* restricted foreign investors' ability to conduct business in Russia. The lack of good corporate governance, the prevalence of complex and often contradictory regulations, rampant discrimination, and lack of legal redress effectively bar foreign investors from participating in the Russian economy.

### B. The Department's Standard

Under Section 771(18)(B)(iii) of the Act, the Department has previously considered both the laws and regulations governing joint ventures and other foreign investment in transition economies, as well as the general climate in the countries affecting foreign investors. In general, those countries which the Department has found to have made the transition to market economy status have permitted foreign investment in all economic sectors, including banking and insurance, and have allowed repatriation of 100 percent of post-tax profits in hard currency, although some restrictions may have existed on foreign investment in strategic sectors or land.[1] In those countries, foreign-owned enterprises operate under the same laws and regulations as domestically-owned enterprises and are protected from uncompensated expropriations.[2] Although the Department has noted some difficulties encountered by foreign investors in countries that have been deemed market economies, including sometimes inadequate information on laws and regulations or problems resolving commercial disputes, each successful transition

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[1] See Poland NME Memo at 13-14; Slovakia NME Memo at 7; Czech NME Memo at 7; Hungary NME Memo at 8-9; Latvia NME Memo at 8-10.

[2] See, e.g., Czech NME Memo at 7; Hungary NME Memo at 8-9.

country was found to have committed to the meaningful pursuit of policies designed to promote further foreign investment.[3]

### C. The Laws and Commercial Climate of Russia Severely Limit Foreign Investment

In June 1999, the Russian Federation passed a revised law governing foreign investment.[4] This law, at least in theory, guarantees that foreign investors have the same rights and protections as Russian citizens, including access to courts, the right to transfer property, and the ability to repatriate profits.[5] The law also contains, however, a provision that permits the government to establish exceptions where necessary for "the protection of the constitution, public morals and health, and the rights and lawful interest of other persons and the defense of the state," providing considerable discretion to the government to alter the laws governing foreign investors.[6]

Notwithstanding the law on foreign investment, the Russian Government has failed in almost every important respect to take the fundamental steps toward structural reform that are necessary to meaningfully open the country to foreign investment. A key impediment is the resistance to foreign investment within the government at both the federal and regional levels.[7] This may explain why implementing regulations for Russia's investment code, which was enacted in 1991 and provides foreign investors with certain protections, have not yet been promulgated.[8] Further, there is evidence that Russian business interests resist competition and are not eager for integration into the world market.[9] This resistance is also evident from the

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[3] See Polish NME Memo at 16; Slovakia NME Memo at 8; Czech NME Memo at 8; Hungary NME Memo at 8; Latvia NME Memo at 8.
[4] See State Dept. Country Report at 7.
[5] See id.
[6] See id.
[7] See DOC Guide at Ch. 3, "Political Environment," and Ch. 7, "Investment Climate Statement."
[8] See DOC Guide at Ch. 7, "Openness to Foreign Investment."
[9] See Peter Reddaway, "Market Bolshevism Harmed Russia," The World Bank, *Transition: The Newsletter About Reforming Economies*, Vol. 12, No. 3 (July-Aug.-Sept. 2001), *available at*

restrictions on the sectors foreigners could invest in and lack of transparency in the privatizations of the early and mid-1990s.[10] The privatizations were structured so as to give insiders control of enterprises and exclude foreign participation, which "rather than creating competition. . . transformed lucrative state monopolies into lucrative private monopolies."[11] A privatization tactic that the government first employed in 1995, the "loans for shares" scheme, involved auctions of government shares in enterprises to whomever would loan the government the most money. The banks that managed the auctions contrived to win them at extremely low prices, and foreign investors were either explicitly excluded from bidding or understood that it would be futile to try.[12] Thus, foreign investors have been unable to participate in the privatization of many of the most desirable enterprises.[13]

The lack of outside participation exacerbates a situation in which government power is abused and the boundaries between the public and private sectors are blurred.[14] The weak corporate governance climate, which permits majority, insider investors to strip enterprise assets, dilute capital, and prevent disclosure of information to other investors, also frequently victimizes foreign investors.[15] The government has only recently made an effort to develop a corporate governance code to prevent such abuses, but the code is not scheduled for finalization until

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http://www.worldbank.org,html/prddr/trans/WEB/trans.htm (citing the vocal opposition to membership in the World Trade Organization during a June 2001 congress of the top Russian association of business leaders.).

[10] See Black, et al., " Russian Privatization and Corporate Governance: What Went Wrong?", 52 Stan. L. Rev. 1731, 1738-46 (July 2000), available from Westlaw.

[11] William Kratzke, "Russia's Intractable Economic Problems and the Next Steps in Legal Reform: Bankruptcy and the Depoliticization of Business," *Nw. J. Int'l L. & Bus.* 1, 14 (Fall 2000) (quoting Janine R. Wedel, *Collision and Collusion: The Strange Case of Western Aid to Eastern Europe 1989-1998* (1998), available from Westlaw.

[12] See Black et al. at 1744. Further privatization continues to appear to be tainted. For example, in 1999 an offshore company believed to be controlled by LUKOil's managers reportedly bought 9 percent of company shares from the government at $3.00 per share at a time when the market price was $8.00 per share. See id. at 1746.

[13] See id.

[14] See Nations in Transit at 325.

[15] See "Measures to Improve Corporate Governance," U.S. Commercial Service Office in Moscow (July 10, 2001), *available at* http://www.bisnis.doc.gov/bisnis/country/rusfed/htm, ("Measures to Improve Corporate Governance").

spring 2002.[16] It is unlikely, however, that any code will have an immediate beneficial effect in a country where the concept of conflict of interest is not widely or deeply embedded in the political and business culture. These conditions make it difficult, if not impossible, for foreign investors to participate as equal players in the Russian economy.

Abusive treatment of foreign-invested enterprises by tax authorities and the weak, corrupt judicial system have also acted as barriers to foreign investment. The government is in the process of gradually adopting a new tax code to replace the confusion of the previous piecemeal, sometimes conflicting rules, but it is still too early to know how successfully the new code will be implemented.[17] Russian tax authorities have been accused in the past of targeting foreign companies for inspection more frequently than domestic companies and of being slow to implement court decisions in favor of foreign companies.[18] The judicial branch itself has not yet fully evolved from the Soviet era and is still subject to political influence.[19] Judges receive low salaries and courts do not have independent budgets, which renders the system vulnerable to bribery.[20] In addition, the judges of the "arbitrazh" courts, which handle most commercial litigation, are for the most part holdovers from the Soviet era and have not been trained in market-oriented legal principles.[21] Foreign-owned enterprises that comply with legal obligations are also frequently at a competitive disadvantage with domestic firms, which routinely cancel their inter-enterprise debts and do not pay external debts.[22] Even though President Putin has

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[16] See id.
[17] See DOC Guide at Ch. 2, "The Government's Role in the Economy;" Ch. 7 at "Transparency in the Regulatory System" and "Tax Reform Pending."
[18] See id.
[19] See John L. Walker, "Building a Legal and Regulatory Framework," (1998), *available at* http://www.frbsf.org (The Federal Reserve Bank of San Francisco), at 55.
[20] See id.
[21] See id.
[22] See *2001 National Trade Estimate Report on Foreign Trade Barriers*, Office of the U.S. Trade Representative, at 385, *available at* http://www.ustr.gov/reports/index/shtml ("USTR Report").

declared that a "dictatorship of the law" is a priority of the government, a package of judicial reform proposals is still under consideration and will, in any event, take years to implement.[23]

Further, the government has explicitly limited foreign participation in some sectors, while discrimination effectively limits participation in others. For example, foreign participation in banking is limited to 12 percent of total bank capital and, while a 1999 law theoretically permits majority foreign-owned insurance firms to operate in Russia, their total market capitalization is limited and they are not permitted to sell life insurance or obligatory forms of insurance.[24] A CBR regulation mandates advance permission for payments for imported services in excess of $10,000, and foreign providers of services have been subject to discrimination by regional authorities (e.g., in obtaining licenses).[25]

Finally, foreign investors face a number of other hurdles to doing business in Russia. These include the confusion of government decrees that regulate commercial activity, accounting practices that are very different from international practices, the prevalence of barter transactions, and the multiple layers of bureaucracy that must be navigated in order to conduct business.[26]

The Russian Federation does not yet offer a commercial climate that is either *de jure* or *de facto* open to foreign investors to the extent required by Department precedent for designation of a transitioning country as a market economy. This fact is quite clearly illustrated by a comparison of foreign direct investment (FDI) in Russia and those countries that have obtained market economy status in recent years. Cumulative per capita net FDI from 1992-99 was only

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[23] See id. at Ch. 3, "Political Environment."
[24] See State Dept. Country Report at 7.
[25] See USTR Report at 383.
[26] See DOC Guide at Ch. 2, 4, 8.

$71 for Russia, compared to, for example, cumulative FDI in the Czech Republic of $823 per capita and Hungary of $1,667 per capita in 1998, before the Department revoked their NME status.[27] This lack of investor participation is especially noteworthy given the potential size of Russia's market, its vast natural resource wealth, and its educated workforce. This indicates that other political and economic failures are having an extremely negative offsetting effect on foreign investors' views of Russia's progress toward a market-oriented economy.

[27] See *Where Has All the Foreign Direct Investment Gone in Russia?*, Harry G. Broadman and Francesca Recanatini, The World Bank (July 2001), at 3, *available at* http://www.worldbank.org/servlet/WDServlet?pcont=details&eid=000094946_01080904131456; Czech NME Memo at 7.